Economic Outlook

Falling home prices, worsening credit availability, shrinking equity values, and growing job losses delivered a crushing blow to the national and California economies in 2008. Consumer and business spending — the core of both economies — plunged during the year. Looking back, the committee of economists that officially dates the troughs and peaks of the national economy decided in late 2008 that the U.S. was in recession and has been since December 2007. While there is no official dating of business cycles for states, it is unlikely that the California economy fared better than the national economy in this difficult environment.

Despite several efforts by the U.S. Treasury, the Federal Reserve, Congress, and the White House to stimulate the national economy and free up credit in 2008, credit appeared to be less available and economic output fell as 2008 unwound. Much more will have to be done in the first half of 2009 to stimulate the economy and free up credit. Economic output will likely fall in 2009 for the first time since 1991.

The outlook for the national economy is for negative growth in 2009, weak growth in 2010, and good growth in 2011:

- Real GDP is projected to fall 1.1 percent in 2009, and grow 1.7 percent in 2010 and 2.9 percent in 2011, as compared to the 1.3-percent growth in 2008.
- Nonfarm payroll employment is forecast to fall by 1.5 percent in 2009, and grow 0.1 percent in 2010 and 1.3 percent in 2011, as compared to a decline of 0.1 percent in 2008.

The outlook for the California economy is also for negative growth in 2009, followed by weak growth in 2010, and better growth in 2011:

- Personal income is projected to grow 2 percent in 2009, 2.1 percent in 2010, and 4.6 percent in 2011, as compared to 3.7 percent in 2008.
- Nonfarm payroll employment is forecast to fall by 1.6 percent in 2009 and 0.5 percent in 2010, and grow 1.4 percent in 2011, as compared to a 0.6-percent decline in 2008.

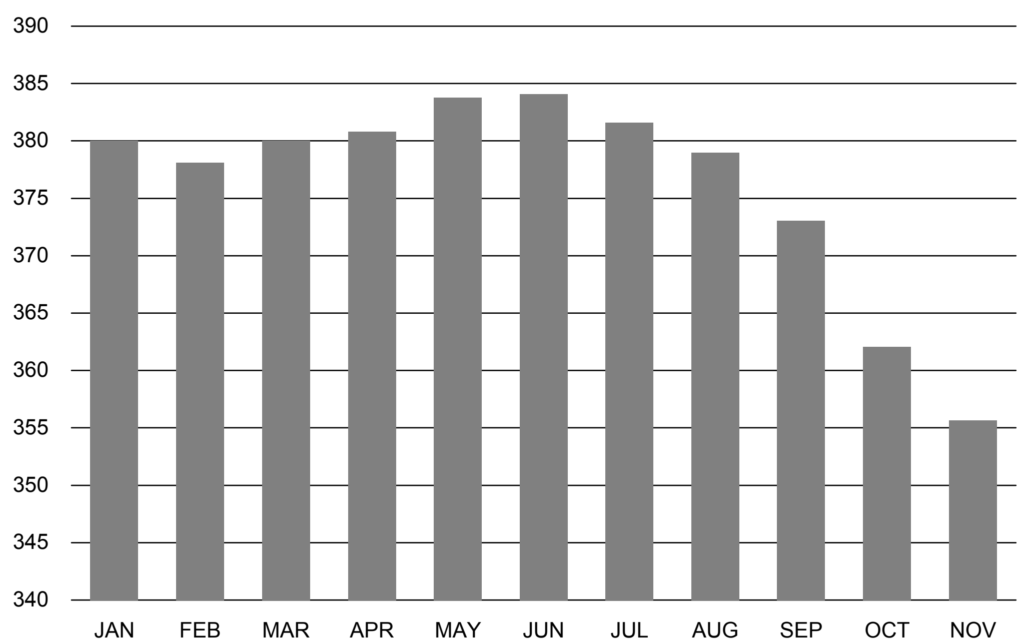
The Nation — In a Worsening Recession

What started as a housing sector slump in 2005 turned into a generalized economic slump in 2008. Most major industry sectors were affected by year-end, most notably retail trade and manufacturing. Consumers pulled back considerably in the second half of 2008, as evidenced by a string of five consecutive monthly declines in retail sales as of November (Figure ECO-01). Total consumer expenditures, adjusted for inflation, fell for the fifth consecutive month in October.

Figure ECO-01

U.S. Total Retail Sales, 2008

$Billions, Seasonally Adjusted



Source: U.S. Census Bureau

With consumers cutting back, companies have reduced their spending on new equipment and structures. Shipments of and orders for non-defense capital goods, excluding aircraft, plunged in the three months ending in October 2008. In addition, the Institute for Supply Management's manufacturing index fell in November to its lowest level since May 1982 — a level that is consistent with recessions in the manufacturing sector and the general economy.

In the meantime, the nation's housing sector continued to struggle. Housing starts fell in November to their lowest level since records began to be kept in 1959. New home sales remained very low and mortgages difficult to get. Residential construction continues to be a sizable drag on overall growth in the national economy.

The continuing problems in the housing sector, the cooling of the manufacturing sector and, particularly, the cutback in spending by consumers have slowed the national economy considerably. The economy has been in recession for 12 months, and should it remain there for another five months, it would be the longest recession in the post-World War II era. Economic output fell slightly in the fourth quarter of 2007 and the third quarter of 2008, but the monthly data on the fourth quarter of 2008 suggest that economic output fell sharply in the fourth quarter.

Data from the labor markets also portray a worsening recession. Nonfarm payroll employment peaked in December 2007 and has declined every month since then. In addition, nonfarm payroll employment was 0.8 percent higher in December 2007 than a year earlier, while in November 2008, nonfarm payroll employment was 1.4 percent below a year earlier. Also, the national unemployment rate rose from 5 percent in December 2007 to 6.7 percent in November 2008.

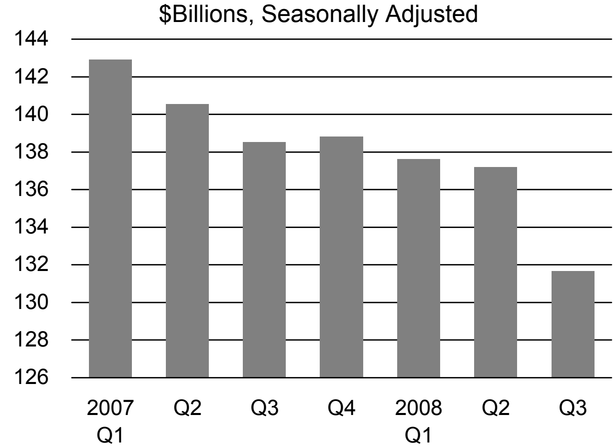
California — Facing a Similar Challenge

The California economy decelerated in step with the national economy during 2008. According to the U.S. Commerce Department, total personal income grew more slowly in the second half than in the first half of 2008. The deceleration in taxable sales has been even faster, with third quarter 2008 sales 4 percent lower than second-quarter sales (Figure ECO-02). Deceleration in new vehicle registrations started earlier — in 2007.

The state's monthly job losses have grown as 2008 has progressed. Through November, California lost 147,400 jobs, or 13,400 jobs per month. But in the first five months of the year, the average monthly loss was 5,200 jobs, whereas in the next six months, the average loss was 20,300. The state's unemployment rate rose from 5.9 percent in January to 8.4 percent in November.

The state's housing sector, however, does not show many signs of additional slowing. In part, that is because the downturn started there. Residential permits, for example, have stabilized at low levels, and monthly construction job losses have become smaller. Sales of existing homes have picked up considerably, but distressed properties are accounting for a good number of those sales. Still, sales of non-distressed existing homes will likely be higher in 2008 than in 2007.

Figure ECO-02
California Taxable Sales
$Billions, Seasonally Adjusted



Sources: California Board of Equalization and California Department of Finance

Private-sector nonresidential building is slowing and will be down considerably from 2007. The value of permits fell every month from July to November.

The Forecast

The California and national economies will enter 2009 with very little, if any, momentum. As a result, the two economies are likely to be very weak in the first half of the year. How long it will be before the economies will be healthy again is difficult to gauge. The economies are not likely to improve much until credit becomes much more available (Figure ECO-03).

Demographic Information

Population Overview

Current administrative records, which are the indicators used in the population estimates methodology, do not show sharp effects on the state's migration or birth rate patterns due to the recent economic downturn. Thus, the projections used for the budget do not reflect any that may occur in the future.

Figure ECO-03

Selected Economic Data for 2008, 2009, and 2010

United States	2008 (Est.)	2009 (Projected)	2010 (Projected)
Real gross domestic product (2000 CW* $, percent change)	1.3	(1.1)	1.7
Personal consumption expenditures	0.4	0.1	1.8
Gross private domestic investment	(6.1)	(15.6)	10.7
Government purchases of goods and services	2.6	0.3	(0.3)
GDP deflator (2000=100, percent change)	2.4	1.8	1.3
GDP (current dollar, percent change)	3.7	0.8	3.1
Federal funds rate (percent)	2.04	0.50	1.20
Personal income (percent change)	4.2	2.1	2.4
Corporate profits before taxes (percent change)	(13.9)	2.5	10.1
Nonfarm wage and salary employment (millions)	137.5	135.4	135.6
(percent change)	(0.1)	(1.5)	0.1
Unemployment rate (percent)	5.7	7.7	8.2
Housing starts (millions)	0.93	0.71	1.08
(percent change)	(30.9)	(23.8)	52.8
New car sales (millions)	6.8	6.8	7.5
(percent change)	(10.2)	(1.0)	10.6
Consumer price index (1982-84=100)	216.0	218.2	222.3
(percent change)	4.2	1.0	1.9
California			
Civilian labor force (thousands)	18,415.2	18,570.4	18,783.1
(percent change)	1.2	0.8	1.1
Civilian employment (thousands)	17,115.2	16,876.7	17,010.0
(percent change)	(0.5)	(1.4)	0.8
Unemployment (thousands)	1,299.9	1,693.7	1,773.1
(percent change)	32.8	30.3	4.7
Unemployment rate (percent)	7.1	9.1	9.4
Nonfarm wage and salary employment (thousands)	15,093.3	14,859.1	14,791.3
(percent change)	(0.6)	(1.6)	(0.5)
Personal income (billions)	1,576.8	1,608.7	1,642.9
(percent change)	3.7	2.0	2.1
Housing units authorized (thousands)	65.3	56.9	80.9
(percent change)	(41.9)	(12.9)	42.2
Corporate profits before taxes (billions)	169.1	164.5	179.9
(percent change)	(6.8)	(2.8)	9.3
New auto registrations (thousands)	1,422.3	1,513.4	1,521.0
(percent change)	(8.4)	6.4	0.5
Total taxable sales (billions)	535.0	503.0	521.4
(percent change)	(4.5)	(6.0)	3.7
Consumer price index (1982-84=100)	225.6	229.2	234.6
(percent change)	3.8	1.6	2.3

* CW: Chain Weighted

Note: Percentage changes calculated from unrounded data.

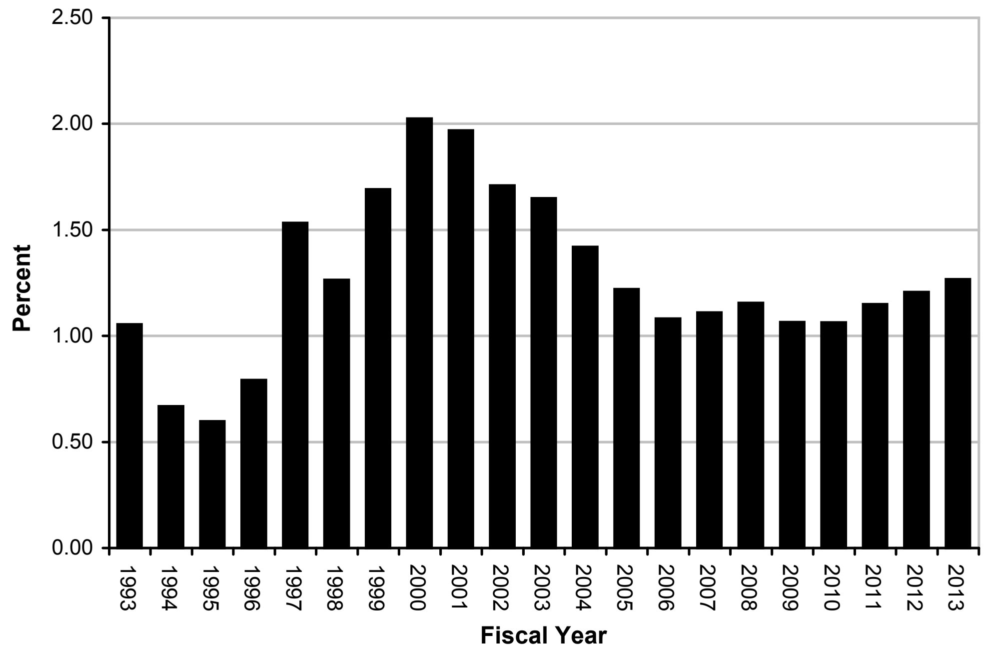
With more than 38 million people as of mid-2008, California's population continues to grow. Despite a slowdown in the mid-1990s, the state has grown in excess of 1 percent per year since 1997.

- The July 1, 2008, estimate of the population is 38,148,000.
- It is forecast to be 38,555,000 in 2009 and 38,965,000 in 2010. This reflects a short-term annual growth rate of almost 1.1 percent.

Through the next five years, the state will grow by an average of 449,000 people each year. Natural increase (more children being born than people dying) will account for three times as much growth (76 percent vs. 24 percent) as net migration (people moving to California from other states and other countries, less those moving out). By July 2013, California will add more than 2.2 million people to exceed 40 million, a five-year growth rate of 5.9 percent (Figure ECO-04).

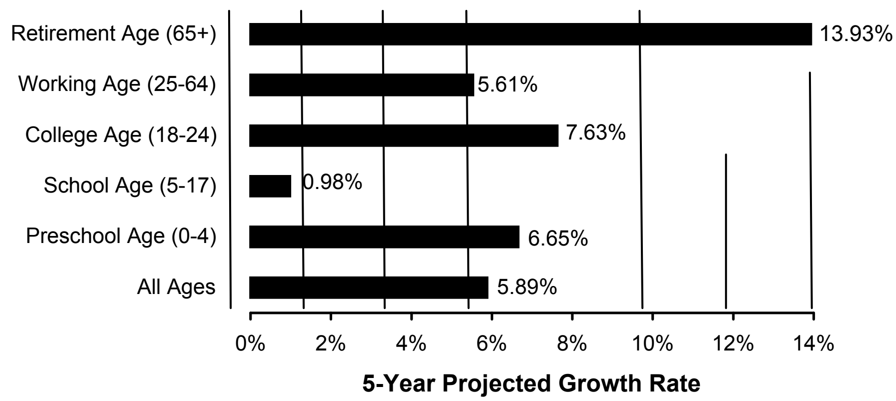
Figure ECO-4

California's Annual Population Growth Rate



- Population growth rates vary significantly by age group. The state's projected total five-year population growth of 5.9 percent is lower than the 6.7-percent growth in the preschool age group. By far, the slowest growing age group over the next five years is the school-age group with a growth rate of 1 percent. On the other hand, the college-age group will grow 7.6 percent. The working age population will grow by 1.1 million, or 5.6 percent and retirement-age group will soar nearly 14 percent (Figure ECO-05).

Figure ECO-05
Projected California Population Growth Rate by Age Group (2007-2012)



- In fall 2007, K-12 public school enrollment was a little less than 6.3 million students. Starting in 2003 and continuing through 2012, school enrollment growth will be slower than that of the general population because the number of births in the state declined in the 1990s. However, it should be noted that births increased again in 2007 for the sixth year in a row.
- Beginning in 2003 and continuing in 2004, K-12 public school enrollment growth was below 1 percent. Prior to these years, enrollment growth had not been less than 1 percent since 1983. School enrollment growth rates turned negative in 2005 and are expected to continue to decline through 2010, at which point they are expected to turn positive. There was a slight jump in school enrollment in fall 2006, but this was due to a change in reporting rather than an actual increase in school enrollment.